In the Supreme Court of the United States

OCTOBER TERM, 1966

No. 396

PAULINE W. ACH, PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE

ESTATE OF ERNEST H. ACH, ET AL., PETITIONERS

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SIXTH CIRCUIT

MEMORANDUM FOR THE RESPONDENT IN OPPOSITION

This case involves the scope of the Commissioner's statutory power under 1954 Code § 482 to reallocate income between entities which are under common control. Section 482 provides:

> In any case of two or more organizations, trades, or businesses (whether or not incorporated, whether or not organized in the United States, and whether or not affiliated) owned or controlled directly or indirectly by the same interests, the Secretary or his delegate may distribute, apportion, or allocate gross income,

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deductions, credits, or allowances between or among such organizations, trades, or businesses, if he determines that such distribution, apportionment, or allocation is necessary in order to prevent evasion of taxes or clearly to reflect the income of any of such organizations, trades, or businesses.

Prior to August 1953, Pauline Ach owned and operated, as an individual, a successful dress shop, earning approximately $30,000 per year. Her two sons were the sole stockholders of a corporation which had previously engaged unsuccessfully in the operation of a dairy business but which, having accumulated substantial net operating losses, had discontinued that business and was inactive and insolvent. The corporation owed a large sum to Ernest Ach, the father of the corporation's stockholders and Pauline's husband. Because of the hopeless financial condition of the inactive corporation, this debt was uncollectible.

On August 1, 1953, Pauline transferred to the corporation certain assets of her dress business in exchange for a non-interest-bearing note for $30,705, which was the assets' book value. She did not, however, transfer to the corporation certain intangible assets—the right to use her name or the name under which she had operated the business, the right to her managerial services, the goodwill attendant upon her identification with and operation of the business, etc.—which the Tax Court found to be the most important and valuable aspects of the business. Thereafter, Pauline continued to manage and operate the dress shop in the same manner as before. Although

the corporation purported to pay her no salary, it did, over the five years here in question (1954–1958), pay Pauline and her husband the bulk of the profits from the dress business, allegedly on account of the corporation's debts to them. And in mid-1959 Pauline's sons transferred to her all of the corporation's stock without further consideration.[1] (Pet. 1a–9a, R. 101a.)

On her tax returns for those years, Pauline reported no income from her activities in connection with the dress business; the corporation reported the profits of the dress business but used the net operating losses previously incurred in the dairy business to wipe out any liability for taxes. The Commissioner took alternative positions, claiming, first, that the net income of the dress business should be reallocated to Pauline under 1954 Code § 482, and, second, that to the extent the income was taxable to the corporation, its claimed net operating loss carry-forward should be denied.

In the Tax Court, petitioners challenged the applicability of § 482 on the ground that Pauline, following the transfer of the physical assets of her dress business to the corporation, was no longer engaged in a "business" and that she did not, therefore, constitute an independent "organization," "trade," or "business" to which income might be reallocated under § 482. The Tax Court found that the most valuable income-earning aspects of the business—the

[1] The lower courts found that Pauline had actually acquired beneficial ownership to the corporation's stock at the time she transferred the assets of her dress business to the corporation in August 1953.

intangible assets—had been retained by Pauline, and that her continued activity constituted a "business." It determined that 30 percent of the business income was attributable to the assets owned by the corporation and the balance to the aspects of the business which remained with Pauline; it therefore held that 70 percent of the income was taxable to Pauline and 30 percent to the corporation.[2] The court of appeals affirmed.[3] (R. 99a–110a, Pet 1a–9a.)

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[2] The Tax Court stated (R. 101a):

> Plainly, [the transfer of assets by Pauline to the corporation] was not an arm's length transaction. The corporation was hopelessly insolvent, and it is utterly beyond belief that any unrelated third party would have sold a prosperous business for a non-interest bearing $30,705.57 note of such an insolvent maker where the level of earnings of that business was about $30,000 a year and rising, and where the seller contemplated continued full-time management of the business without compensation. Notwithstanding testimony indicating otherwise, it is all too clear to us on this record that Pauline was acquiring control of this moribund corporation for the purpose of attempting to utilize the net operating loss carryover of the dairy business, to offset the resulting deductions against earnings of her successful dress business and to obtain the actual benefits of those tax-free earnings by having the corporation pay off, first, her $30,705.57 note, and then the notes of some $280,000 held by her husband which were otherwise uncollectable—all of which would be received free of tax!

[3] The lower courts also sustained the Commissioner's alternative position that 1954 Code § 269 prevented the corporation from carrying forward its previous net operating losses from the discontinued dairy business, and thus that the corporation was taxable on the 30 percent of the dress business income which was allocable to it. The corporation has not filed a petition for a writ of certiorari and the lower courts' determination on that issue is now final.

The decisions of the lower courts were correct. There is no conflict of decisions or other ground warranting further review. . .

1. Petitioners argue that Pauline's activities were not sufficient to constitute a "business" and that the Commissioner was thus precluded from reallocating income to her under § 482. The Tax Court found that Pauline's retention of the intangible assets and her use of them in the continuing operation amounted to a "business." Whether a particular taxpayer's activities are sufficient to constitute a trade or business within the meaning of the Code depends principally on the facts of each case, and the question is not readily susceptible to a rule of general applicability. Moreover, this Court has reviewed several cases involving this question under other sections of the Code,[4] and there is no present need for the Court to review this question in the context of the particular facts of the case at bar.[5]

2. There is no conflict between the instant decision and the cases cited by petitioners (Pet. 7–8). In *Whipple* v. *Commissioner, infra,* this Court held only that "[d]evoting one's time and energies to the af-

[4] See, *e.g.*, *Whipple* v. *Commissioner*, 373 U.S. 193; *Burnet* v. *Clark*, 287 U.S. 410; *Higgins* v. *Commissioner*, 312 U.S. 212; see also *Folker* v. *Johnson*, 230 F. 2d 906 (C.A. 2); *Schmidlapp* v. *Commissioner*, 96 F. 2d 680 (C.A. 2); *Noland* v. *Commissioner*, 269 F. 2d 108 (C.A. 4).

[5] Since, as the Tax Court found, Pauline had retained valuable intangible assets, petitioners are incorrect in asserting (Pet. 6) that the instant decision will apply to any case where "a controlling shareholder * * * has elected not to demand from the corporation a salary commensurate with the value of his service."

fairs of a corporation is not of itself, and without more, a trade or business of the person so engaged" (p. 202). However, the Court recognized that if additional facts were present, a court might be justified in holding that the shareholder-employee was engaged in a trade or business (pp. 203–205).

Nor does the instant decision conflict with *Commissioner* v. *Gross*, 236 F. 2d 612 (C.A. 2), since that case involved only 1954 Code § 61. The Commissioner did not there attempt to invoke, and the courts thus did not consider, the special remedial provisions of § 482, the provision here in question. Cf. *Tennessee-Arkansas Gravel Co.* v. *Commissioner*, 112 F. 2d 508, 510 (C.A. 6).[6]

Finally, *Moline Properties, Inc.* v. *Commissioner*, 319 U.S. 436, is entirely inapposite since the lower courts did not refuse to treat the corporation as a separate taxable entity. On the contrary, the Tax Court found there was a genuine transfer of tangible assets to the corporation and that the portion of the dress business' income properly attributable to those assets (30 percent) should be taxed to the corporation (R. 101a–102a, 106a).

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[6] In *Tennessee-Arkansas* the taxpayer corporation rented property to a related corporation but did not collect any rent. The Commissioner attempted to tax the lessor corporation on rental income without giving the lessee corporation a corresponding deduction for rent paid. The court held that the Commissioner may not create income in this manner, but suggested that the Commissioner might (as he has done in the instant case) use § 482 or its predecessor to reallocate some of the reported income from one related taxpayer to another.

Therefore, the petition for a writ of certiorari should be denied.

Respectfully submitted.

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